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THE COMPARATIVE YIELD ON TRADE AND PUBLIC SERVICE INVESTMENT

What constitutes a fair return upon capital invested in a business enterprise? Recent efforts of the Interstate Commerce Commission and of the various state public service commissions to regulate rates (or more truly to regulate profits) have made this a vital question. Broadly, the answer is given that such rate of return must be allowed as will attract capital in sufficient volume to develop and maintain the particular industry. As a statement of a ruling principle this is doubtless correct, but it is not a practical answer for, What is the fair rate of return that will attract capital to the industry? It does, however, suggest the fundamental truth that the investor has a right of selection and is therefore the final regulator; and, though for those who have already invested the choice has been exercised, the effect of regulation on the potential future investor is a question of paramount importance to the public.

The saving to the public which might result from reducing the limit of return on capital already invested in public utilities by, say, one or two per cent, considered by itself, is doubtless a notable sum, but it is insignificant if considered, as it should be, in relation to the value of attracting and inspiring with confidence the enormous further capital which requires yet to be invested in the extension of the facilities now established and the development of new ones if this country is to attain its full development and prosperity. So not only justice but self interest dictates that the public should not restrict capital already invested to a rate of return too small to attract new capital.

Eventually, if rate regulation is applied consistently, experience will indicate with some measure of accuracy the rates that are adequate to attract capital to railroad and other public service securities. In the meantime, however, there is pretty sure to be much groping around with consequent damage to the public as well as to the investor. Evidence is not lacking that many investors are inclined, for the time being at least, to allow the

regulating bodies to work out their experiments upon the other fellow while they place their money either where it will be as nearly safe as may be, as in a savings bank or in high grade bonds, or invest it where it will yield a larger return than it is likely to yield if invested in enterprises subject to regulation.

Thus the question really turns upon the competition for money. And money has its law of attraction, operating as certainly as the law of gravitation. Every investor is seeking safety and return. One may attach greater value to safety while another desires, if possible, a larger return even though attended with a somewhat higher degree of risk, thus taking the speculative or gambling chances; and much skill is displayed in devising types of securities that will appeal to the different classes of investors.

In the present uncertainty as to the maximum rate of return an investor in a public service corporation should be allowed to receive (and in passing it is important to note that it is nowhere proposed to guarantee even a minimum return), it would seem logical to inquire what return can be secured from investments in enterprises not subject to public regulation. Many attempts have been made in this direction with at best but incomplete or indifferent success. It must be remembered that there is a tendency among regulating bodies to fix a rate of return to be allowed on the amount actually invested in the business and that, substantially speaking, the intangible values, such as good-will, patents, etc., so frequently met with in industrial enterprises, and the so-called franchise and going concern values in public utility companies are to be eliminated from the capital sum upon which a company subject to regulation may earn a return. The inclusion of these intangible values, which has been almost universal until quite recent years, by both utility and industrial companies under the general heading of property or other equivalent title in corporation balance sheets, renders it impracticable to determine the rate of return upon the investment even in the case of corporations publishing reasonably full reports. Undoubtedly, the present tendency in the case of new industrial companies is to set out as a separate balance sheet item the investment in good-will or other intangible assets, but the number of instances where this is done is as yet relatively small. It is therefore not possible to compile from the published reports of corporation statistics that would be upon a basis permitting accurate conclusions to be drawn therefrom. In so far as these statistics are accessible, whether found

in the form of corporation annual report or of prospectus issued in the flotation of securities, they show with remarkable uniformity, a rate of return in excess of the maximum yet allowed in any representative case by any commission in determining rates.

It is true even of our national banks, than which no line of business is perhaps rightfully regarded as more safe. The Comptroller of the Currency reports that the net earnings upon the capital and surplus of all the national banks averaged 8.64 per cent for the forty-five years ending June 30, 1914. In only two of the last seven years of this period have the earnings ranged below this general average, and then but slightly, while the average for the seven years is 8.98 per cent. It will be observed that this rate of earnings is upon the surplus as well as upon the capital and if it is objected that bank surpluses are frequently understated and that secret reserves commonly exist, it is sufficient to say in reply that in so far as this may be true, the profits must have been understated by an equal amount and therefore the rate of earnings stated by the Comptroller of the Currency should, if anything, be increased.

In an effort to supplement the meager data obtainable from published records, I have made a study of a number of audit reports prepared by my firm with a view to determining in each case, so far as could be done, the investment exclusive of intangible assets of the character above mentioned, the return, and the resulting rate. The reports were selected purely at random from our files excluding only those upon enterprises subject to regulation or otherwise outside the field of inquiry, such as reports upon governmental bodies, charitable institutions and the like. It was necessary to discard a considerable proportion of the reports selected for examination principally because of their failure to disclose the measure of the intangible values included among the assets. This process of elimination, however, left 158 reports showing the amount of the investment and the profits, after payment of operating and management expenses, earned by enterprises engaged in a wide range of business activities and scattered throughout the United States. The contents of individual reports and the identity of the clients must, of course, be withheld, but certain group generalizations can be made without violation of professional confidence; and I trust they will throw some light upon the return earned by capital invested in lines of business open to competition but not subject to governmental regulation of rates or earnings.

It may be objected that an accountant's reports are likely to be confined to the more prosperous concerns and will not for this reason give a fair indication of general conditions. The premise here is correct only in part. Every important accounting firm is brought into contact, sometimes in bankruptcies and receiverships, sometimes through disputes between owners, sometimes to determine the efficiency of a management or to locate the reason for a falling off of earnings, with enterprises that are unprofitable. Even were the charge wholly true it would be relatively unimportant, inasmuch as the regulation of rates is merely an effort to limit the maximum earnings and does not concern itself with the failure of a given utility to earn that maximum.

The aggregate investment represented by the 158 audit reports was $406,829,358. This relatively small total for so large a group is attributable to the fact that reports upon the accounts of most of the very large concerns had to be set aside for reasons indicated above. The annual profits remaining for the enjoyment of this capital, after providing for all costs and expenses of operation and management including depreciation of plant and equipment, were $55,613,659 or 13.67 per cent. The periods covered by these reports are not uniform, but in most instances the accounts are for the calendar years 1912 and 1913 or for fiscal years ending in 1913 or 1914, while in a few instances the period covered is a fiscal year ending in 1912. During this time business conditions have been generally unfavorable and some lines of trade have suffered considerable depression. It may therefore be assumed that the profits earned during the past two or three years have been not more than a fair average; furthermore, as the present study is confined to audited accounts, the results may be expected to be more accurate than statistics usually are.

A few of the concerns under review show an actual loss on their operations. Only four, however, fail to earn any part of their interest charges, and these have a total investment of only $1,527,914 and show an operating loss of $26,993. Nineteen more having an investment of $60,358,131 earned less than 6 per cent and fourteen of these businesses earned less than 5 per cent. Of the entire group of enterprises therefore twenty-three, or 14½ per cent in number, earned less than the usual legal rate of interest after paying the costs of operation and management.

A further analysis of the 158 reports under examination shows that upon the invested capital:

In	117	cases	8	per	cent	or	more	was earned
"	97		10	"	"	"	"	" "
"	86		12	"	"	"	"	" "
"	70		15	"	"	"	"	" "
"	44		20	"	"	"	"	" "
"	28		25	"	"	"	"	" "
"	17		30	"	"	"	"	" "
"	10		40	"	"	"	"	" "

There appears to be a widespread belief that large corporations have crowded the small business man if not to the wall at least to the point where he finds increasing difficulty in making an adequate profit. Many intelligent persons sincerely believe this to be true and are deeply disturbed thereby. It is interesting and perhaps not without significance to find from the reports now being considered that fifty-nine of them relate to enterprises each having an investment of $1,000,000 or more and having an aggregate investment of $379,511,380 upon which the earnings amounted to $51,317,952 or 13.52 per cent. Only one of these concerns failed to earn any profits and its loss for the year was only a fraction over 1 per cent upon the investment of $1,200,000, so that its bearing upon the general average is unimportant. Twenty-five reports relate to businesses having an investment of $100,000 or less and may therefore be taken as indicating so far as they may go the situation of the so-called small business man. The total investment in these twenty-five cases was $1,156,827, while the profits are found to be no less than $324,114 or 28.02 per cent. Another compilation shows that the average return upon the investments of $500,000 or less was 16.67 per cent. The smallest investment shown by any of the reports is that of a retail store employing a capital of $9,250, upon which for the year 1913 it earned 34.27 per cent. The highest rate of return in the group is found in a little establishment having an investment of $13,000, while the second in rank employed slightly less than $51,000. Of the ten instances mentioned above as having earned over 40 per cent each, five had an investment of less than $60,000 and all but two were below $200,000.

In determining the profits of a small business, the question of management salaries is relatively more important than in a large one and the thought may arise that a sufficient allowance for this expense might perhaps reduce largely the profits shown for the smaller enterprises. To this suggestion, two replies may be made: first, that a careful effort was made to exclude reports upon ac-

counts which did not make reasonable provision for management salaries; and, second, that since 1909, when the corporation tax law was enacted, the tendency among the smaller corporations, where the officers are usually the principal stockholders, has been toward a liberal allowance for salaries and a consequent reduction of taxable profits. It is not necessary to imply, nor do I so imply, that by the use of this means there has been any extensive evasion of taxation; but the corporation tax law permitted a deduction to be made for management salaries and it has not been customary for corporations either to fail to claim the deduction or in fixing the amount to err on the low side.

In so far, therefore, as the statistics before us indicate, it is very clear that the day of the small business is not yet past. The initiative and enterprise of the man of moderate means still bring, as they deserve to bring, a reward far beyond anything that may reasonably be hoped for by the employers of great aggregations of capital. The figures given for the profits of small enterprises may seem surprising to many. If this is so it will be largely because public impressions are based upon profits divided rather than upon profits earned. In most growing businesses the difference is substantial, as it is seldom desirable or practicable to distribute the whole of the profits.

Incidentally, it may be pertinent to suggest that the ideal type of regulation should provide not only rates for the distribution of profits but for rates of service that while not unduly burdensome upon the payers should not be reduced except where they provide a substantial excess over:

(a) a fair distribution of profits to the owners;

(b) a substantial sum for betterment and surplus to be held subject to definite restrictions and to be deducted from the capital sum in any future calculation of return.

It should be borne in mind that the theory of governmental regulation is based largely upon the assumption that public service corporations, from their very nature, are or should be monopolies, or, at least, not subject to the same competition, quantitatively or qualitatively, as other enterprises; in other words, that regulation is, to a large extent, a substitute for competition as the prime factor in the attainment of reasonable rates. And yet, as indicated below, commissions have been exceedingly loath to grant to public service corporations a return comparable to that being earned by unregulated enterprises, even where the latter are exposed to intense and active competition.

Contrasted with the profits earned by businesses not subject to regulation, the maximum return thus far allowed by the various state commissions is, so far as I have been able to ascertain, only 8 per cent. That is the most the owners can hope for and in some cases a smaller maximum is fixed. Among the states in which decisions upon this question have been rendered by courts or commissions, reference may be made briefly as follows:

Maximum return allowed by state commissions (per cent).

	Telephone and Telegraph	Gas and Water	Street Railway
Illinois	8		
Kentucky	7		
Maryland	8		
California		8	
Iowa		8	
Washington			7
Missouri	6	7	
New Jersey	8	8	
New York	8	7½	
Nebraska	7		8

The United States Circuit Court held in the Northern Pacific case that 7 per cent per annum was a fair return while in the Arkansas rate case 6 per cent with a possible 1½ per cent additional in lean years was allowed. Both of these cases were decided in 1911.

In every comparison of the rates of return, recognition must, of course, be given to the difference in the conditions affecting business generally and those under which public utilities are operated with the consequent greater measure of confidence displayed by careful investors in favor of the securities of companies in the latter field. At the same time it must be admitted that this margin of confidence in securities of utilities as against industrials is diminishing and the marked disparity of even less than ten years ago no longer exists.

Having in view the earnings of capital in businesses outside the field of public regulation and the increasing stability of such enterprises it does not seem too much to say that nothing is definitely settled by the decisions thus far rendered in rate cases. The commissions and the courts have been feeling their way among issues too often befogged and possibly with eyes too constantly

fixed upon interest rates and dividends and without giving sufficient consideration to the speculative element of profit that has made possible the rapid development of electrical and other utilities in recent years. It is the desire of every one that this process of development shall continue unabated. It can not continue if capital finds greater attraction elsewhere. Not the only attraction but certainly one of the most important is the rate of profit capital may reasonably expect to earn under competent, enterprising management.

It is my hope that the facts herein given, culled as they have been from a group of business enterprises at once too small to justify the drawing of final conclusions and yet a group much more extensive in variety of activity and in territory than, perhaps, has heretofore been subjected to a similar study in equal accuracy of detail, may prove suggestive; and, what is much more important, I trust what has been said may serve to incite a more comprehensive investigation of those business facts ordinarily stated in terms of profit and loss.

J. E. Sterrett.